RICHARD RUSSELL'S DOW THEORY LETTERS INCORPORATED

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May 17, DJIA 10353.08; PTI 5300; A-D Ratio +3.50
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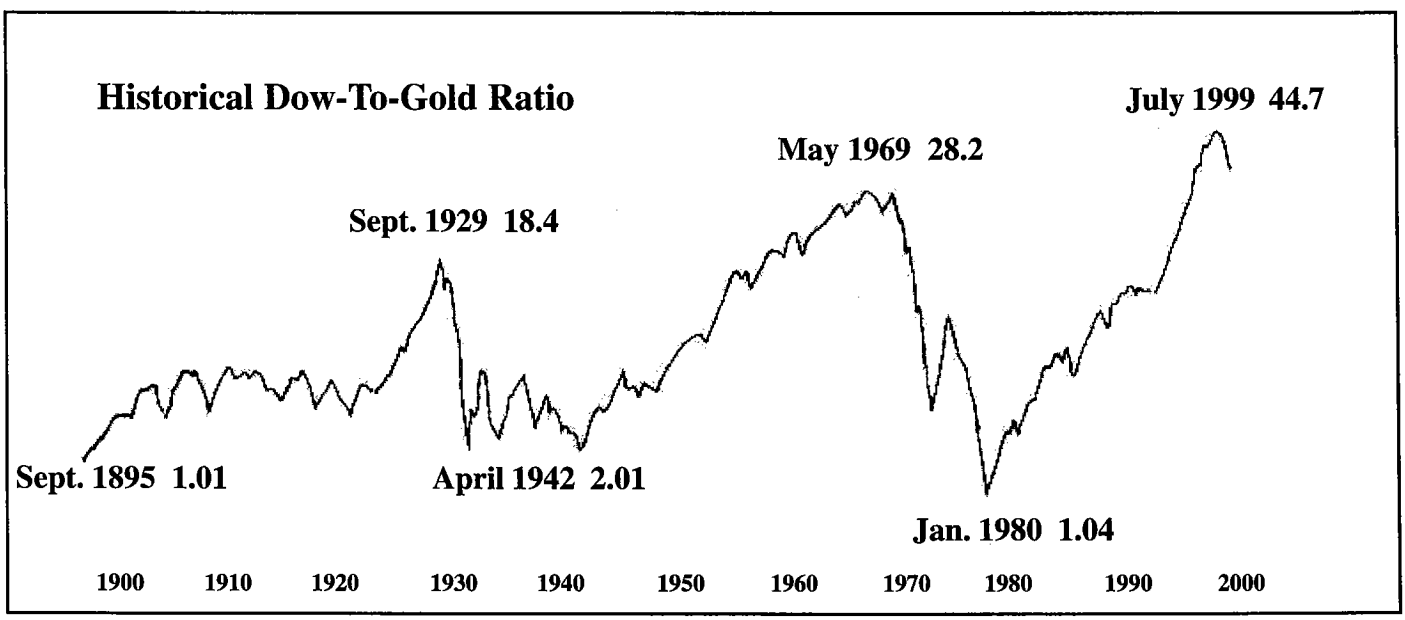
S&P Yield: 1.48% S&P p/e: 43.90
Gold 50-Day MA: 306.30

A CRITICAL REVERSAL IN THE RATIO – An historic turn. I'm starting with this extraordinary chart of the Dow divided by gold or the historic Dow/Gold ratio.

In July of 1999 the market did something that has been done only twice before in the last hundred years. The Dow relative to gold turned down on a trend basis. Let's trace the history of this ratio. Back in 1895 gold was cheap. The Dow at that time would buy an ounce of gold. During the 1920s a great bull market took the Dow to a high of 381 (1929) at which time the Dow would buy 18 ounces of gold.

From the '29 high, the market collapsed with the Dow sinking to a low of 42. A short bull market followed, but that bull market topped out in 1937, only to be followed by another bear market that took the Dow down to 92 in 1942. At the '42 low the Dow would buy only 2 ounces of gold. From the World War II low set in 1942, a great bull market was born. The bull market carried prices steadily higher into the 1960s. In May of 1969 the Dow could buy 28 ounces of gold.

From the high ratio of the late-1960s, the ratio declined and by 1980 with the Dow at 1000 and gold over 800 the Dow would buy a little over 1 ounce of gold. That was the lowest Dow/Gold ratio in history.



From the early-1980s Wall Street gave birth to the greatest bull market in stock market annals. By July of 1999 the Dow could buy more gold than ever before in history – the Dow could buy over 44 ounces of gold! Next came the turn, and the ratio turned down. As I write, the Dow will still buy over 33 ounces — but the ratio continues to decline.

Now the following is just my own opinion. The ratio started in 1980 from its lowest point in history and by 1999 the ratio rose to its highest point in history. Therefore, I would think that the correction or reversal of this huge rise in the ratio will be a major decline, a decline to the point where the Dow again might buy only 1 ounce of gold or even less.

This will require either a huge rise in gold or a massive decline in the Dow – or probably both. On this basis I believe all subscribers should own gold or gold shares or preferably both. I realize owning gold and gold shares is foreign to most of my subscribers (except my old-timers). Nevertheless, owning gold is a necessary part of an "investment-survival" program in the current bear market. So my dear subscribers — do it, do it, do it.

THE FEDERAL RESERVE - I'm going over this picture again, because I want to be certain that all my subscribers understand the big picture.

What we're seeing now is the Federal Reserve pitting its inflationary ability against the forces of debt and contraction. The contractionary forces stem from the massive build-up of debt in the US plus the powerful competition coming from nations such as China, Maylasia, VietNam, India, etc.

The Fed was established in 1913 as a private institution empowered to take over the money creation powers of the United States. The Fed was an outgrowth and a reaction to the Panic of 1907, a panic that brought down many banks and created chaos in the financial community. The idea of the Federal Reserve or a central bank was to establish an institution that could expand or contract the money supply of the US at will. Thus the Fed would create an "elastic currency," a currency which could inflate any time that the economy was contracting or in trouble – and contract in times of excess investor exuberance or in times of inflation. The Fed has one remedy for any recession or any emergency in the economy. The Fed's remedy is always the same. That remedy is inflation – an expansion of the money supply along with a drop in short-term interest rates.

I often ask myself, "What is Greenspan thinking about?" Here's a guy who grew up believing in gold and stating that gold was our only defense against the inflationary proclivities of the Federal Reserve. But now we see Greenspan leading the Fed, the same Fed that has been inflating the money supply for the last 89 years. What can Greenspan be thinking? My own "take" on Greenspan is as follows. He must, on a deep level, feel guilty about his (the Fed's) action of wide-open expansion of the money supply. How does he handle his guilt? He does it by being obsessed with inflation.

But the irony and the lie is that a definition of inflation is **AN INCREASE IN THE MONEY SUPPLY.** Thus, the great lie of the Fed gang is that they create inflation and then present themselves as the nation's noble defender against inflation. The Fed has a huge problem today. The problem is that it has embarked on the greatest inflationary expansion in its history, but so far the economy has responded very sluggishly. Or let me put it another way – the Fed may have (at least so far) prevented the economy from totally collapsing under the weight of a mountain of debt.

Greenspan's great fear, I believe, is that the US will turn into a version of Japan, the same Japan that has been in recession during most of the last decade.

Remember that the bear market on Wall Street began with a massive build-up of debt, a mountain of debt that is still expanding. This is debt that is owned by US consumers, corporations, the federal government, states and cities. Every-

where you look in the US the story is the same — towers of debt. The Fed's remedy for debt is always the same. Sanitize the debt via INFLATION. Since our debt is denominated in dollars, make the dollar worth less. The less the dollar is worth, the less onerous the debt becomes. Pay off debt with cheaper and cheaper dollars. It's the Fed's way. Since 1940 the purchasing power of the dollar has declined 95%. I'm 78, and I'm in an excellent position to see what's transpired in the 65 years since I was a kid. For instance, I remember new Fords selling for $450. I remember good dinners for less than a dollar. I remember men's suits at $30. I remember subway rides from one end of Manhattan to the other for a nickel.

The great fear of the Fed is that the debt mountain built into the US will become out of control — that the economy will sink into a severe recession and that consumers en masse will just "go under," suffocating in the black hole of their own debt. The bear market in stocks is beginning to damage consumer sentiment as far as Wall Street is concerned. In the May 8 issue of the *Wall Street Journal* there's an article with the headline, "Main Street Loses Faith in Stocks."

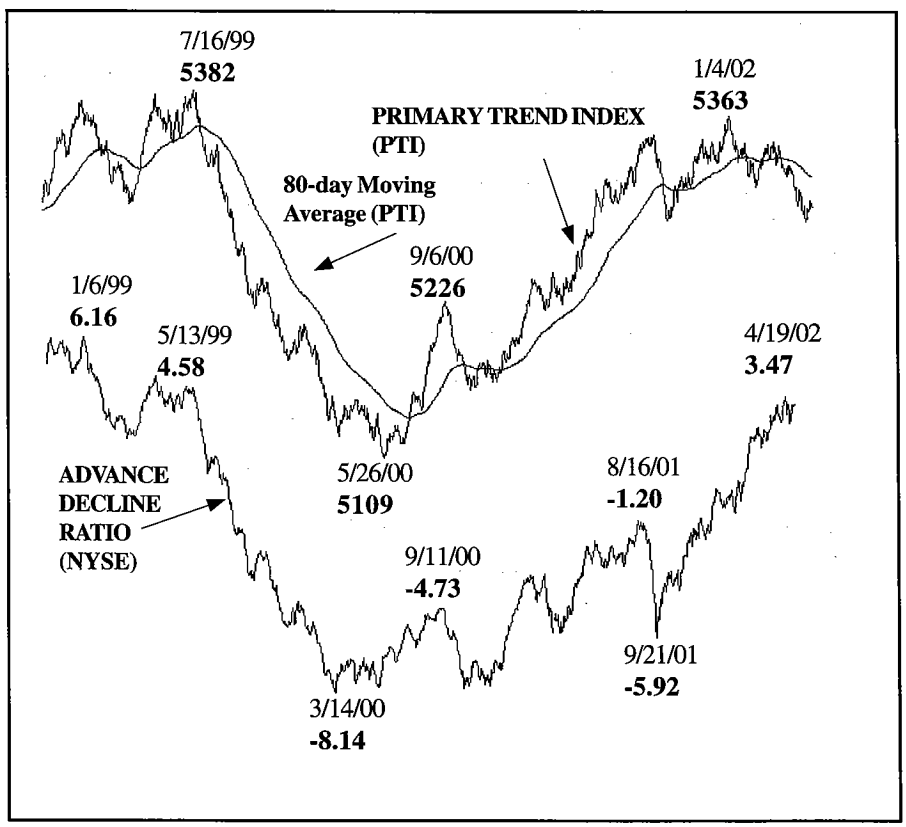
So what's the hope for consumers? Why it's real estate. This is where the money is now. And in order for real estate to prosper, you've got to have financing, cheap financing. Which is one big reason why the Fed is keeping rates low. The event that has "saved" the consumer and the US economy so far has been the inflationary rise in housing. Had it not been for the rise in housing, the economy would almost surely now be in a deep, grinding recession.

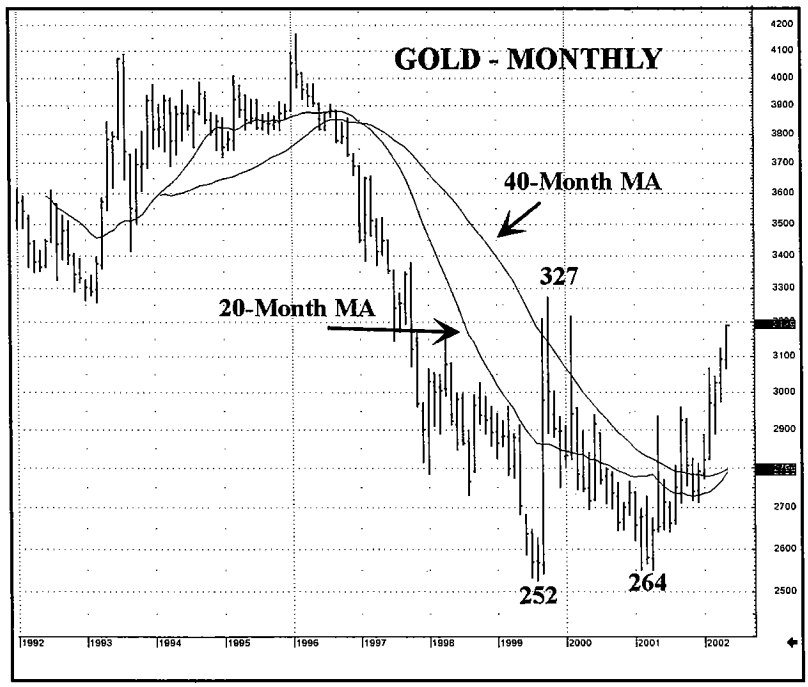
So the big picture can be expressed in a phrase that I coined years ago. The phrase is **INFLATE OR DIE.**

The Fed has embarked, as it always does, on a highly inflationary path. Further complicating the situation for you and me is the question – "How do we defend ourselves against the Fed and its policy of inflation during a prolonged bear market"?

Ah, that's what I've been getting around to. My answer is two-fold – compounding our investments plus gold. Unless the debt situation goes out of control (and it could) and the economy spirals into depression, the odds are that the purchasing power of the dollar over the coming decade will continue to decline.

My own defense against a depreciating dollar is compounding. This requires building a portfolio of income-producing investments – reinvesting the income from that portfolio — and periodically adding to that portfolio with more stocks or bonds. If you can buy securities that yield say 5% and continue to add to the portfolio with securities paying 5% and continue to reinvest all income from that portfolio you can keep up with the Fed's policy of inflation. One caveat is that you must buy top quality securities, whether they are stocks or bonds. Obviously, if you buy junk securities and they go belly-up or collapse, the compounding system is not going to work.





MONEY – Something very strange is happening. Strange because it's happening now, but not strange in terms of history. No, it's happened many times before.

What's happening is that there is a rising distrust of fiat or paper currencies. Today there is no definition of any of the three major currencies. There is no definition of a dollar, a yen or a euro. These currencies are defined simply in terms of each other. A dollar is worth so many yen, so many euros. A euro is worth so many yen. A yen is worth so many parts of a dollar.

These currencies are created by the various central banks; they are created at will. As a government over-spends and runs a deficit, the required amount of currency is created "out of thin air" by the given central bank.

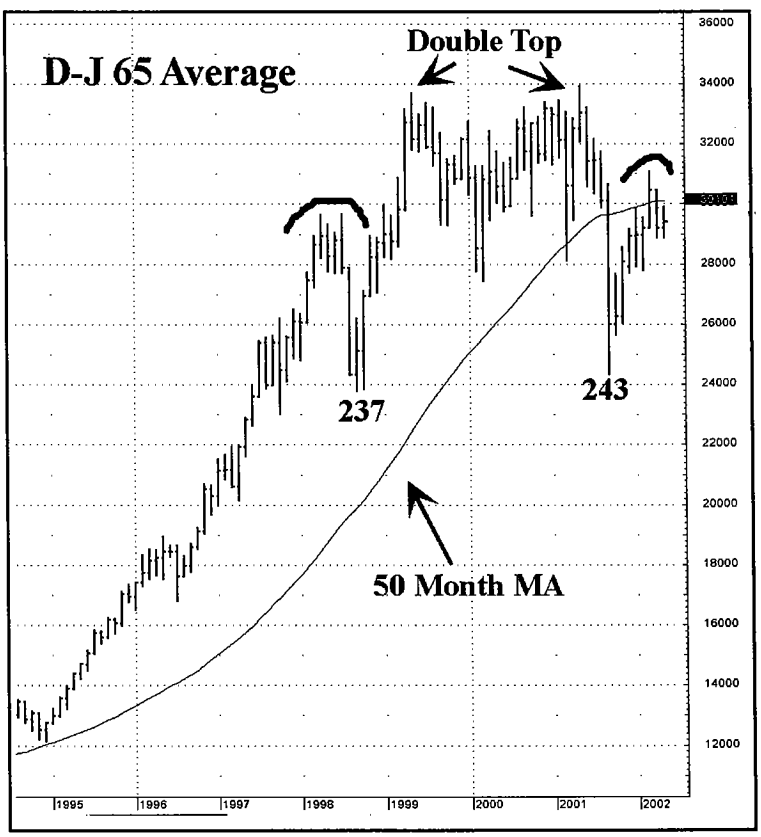
But as things stand today, there is competition among the currencies. The dollar has been strong for many months. The US is fortunate in that it has been able to trade its Fed-created dollars for actual merchandise from other nations. The paper the Fed creates at will serves to buy merchandise and services and raw materials from other nations. But as the world starts to choke on US dollars, the dollar becomes less and less wanted. At some time we might even see the time when other nations don't want dollars at all.

The dollar is the reserve currency for the world's central banks. Every central bank holds billions in dollars. But if the dollar starts to sink against other currencies, the central banks will move to diversify. Will they diversify into Japan's yen, Japan with the wobbly economy? Maybe to some extent. Will they diversify into euros, a new and untested currency? Maybe to some extent.

And then there's gold, which the central banks have been selling at prices well below the current price of gold. Will the central banks do a reversal and diversify into gold? Maybe, to some extent.

The accompanying chart is a monthly chart of gold going back to 1991. I show two long-term moving averages, a 20-month MA and a 40-month MA.

Back in January 1997 the 20-month MA of gold broke below the 40-month MA, rendering a long-term sell signal. The 20-month MA remained below the 40-month MA for roughly five years.



As you can see on the chart, the 20-month MA turned up in October 2001 while the 40-month MA turned up in January 2002. Right now the 20-month MA is just about to cross above the 40-month MA. If or when that happens, we will receive a long-term bull signal for gold.

How long will that bull signal be good for? Obviously, I don't know, but if I had to guess I'd say three to five years. That's how long I think the bull market in gold could last.

D-J 65 Stock Average – The D-J 65 Stock Average is an interesting composite that not many people follow. The Dow 65 is a composite of the 30 D-J Industrials, the 20 D-J Transports and the 15 D-J Utilities In my studies over the years, I have found that the D-J 65 often leads the rest of the stock averages. For this reason, I watch the Dow 65 on a daily, weekly and monthly basis.

I'm including the monthly chart of the Dow 65 on page 4. Note that the monthly chart has assumed the form of a complex head-and-shoulder top pattern. We see the left shoulder, a double head, and the market is now "working" on the right shoulder. I have also run a 50-week moving average on the chart. Note that in September 2001 the Dow 65 broke below the 50-week moving average, and it has remained below the 50-month moving average ever since.

Major support for the Dow 65 stands at 235, substantially below the current price of 295. At any rate, I will continue to monitor the action of the Dow 65. It's an important broad index that few people follow today.

NOTES & QUOTES - Wall Street's beaten strategists are saying "bye bye" to Wall Street. An article in the May 23 issue of *USA Today* headlines it, "Unpredictable Market Bursts Experts' Bubble. New Generation Steps Up as Bulls Bears Alike Are Knocked Off Their Pedestals." The golden age of the Wall Street guru has gone the way of the 1990s bull market.

I've always said that "there are no geniuses on Wall Street, only geniuses for a while." The bear market has taken care of the great gurus of Wall Street. Those who never knew there was a bear market have left or been fired. Those who stayed bullish through the bear market have been demoted, quieted or given a pink slip.

The bear has taken care of the experts who were afraid to call the bear a bear. And for those who stayed bullish out of ignorance or deceit, they've been given the heave-ho. Or if they're still around, they will be given their walking papers.

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With the US on a relentless hunt for terrorists, those Arabs (and there are many wealthy Arabs) who have been financing the terrorists, have to be worried. When people worry they protect themselves. Thus, many Mideast Arabs are moving their money out of dollars and into yen and euros – and into gold. This could mean a massive transfer of funds out of dollars and into the only real money – gold. And by the way, the Arabs are, and always have been, big fans of gold.

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I was most interested to read about my old friend, Chris Wood in the May 24 *Wall Street Journal.* Last I heard Chris was writing for the *Economist.* But now I learn from the *Journal* that this brilliant fellow is editing his own newsletter that is called "Greed & Fear." The *Journal* describes it as "a widely read weekly commentary that many avid followers say provides some of the most lively and candid insights into emerging markets." Chris writes from Jakarta, Indonesia.

Because I have a lot of respect for Chris, I was most interested to hear what he thought about the US position. Here it is, as reported in the *WSJ* – "He says the collapse of technology stocks and of Enron have set in motion a US version of the financial crisis that ripped through Asia in 1997 and 1998. 'Only it will be so much bigger than anything that ever happened in Asia,' he says.

"Indeed, he is expecting the Nasdaq to fall to 1000, a further 40% decline from its current level . . . In the US he sees the crisis unfolding slowly, grudgingly, so that years will pass before the lessons take hold. 'Earnings growth and equity returns in the US will disappoint for the next 10 years,' he maintains. 'So people will be forced to turn to emerging markets because that is where the returns will be.'"

INVESTMENT POSITION – The bear remains in the box. The bear went into the box in September 1999, and he's been there ever since — or ever since the Dow Theory bear signal, that is. During the time since September 1999 a lot of water has flowed UNDER the dam. I'd venture to say that most people have lost money in stocks since September of 1999. But hope springs eternal, even in the stock market.

There is one caveat to that adage. Hope springs a lot in the stock market, but hope is not eternal. I say that because before a bear market ends, hope is abandoned. In fact, that's one characteristic of the bottom of a great bear market. It's called "the abandonment of hope."

It may sound cynical but the only cycle in the stock market I subscribe to is the cycle which evolves as follows – at the end of a bear market we see the wholesale abandonment of hopes. Then as the new bull market moves along hope is revived, and at the bull market top hope is in full bloom along with greed and optimism. Then the cycle takes hold again, and the market heads down. As the market declines optimism slowly fades and hope is held in check. Finally at the bottom, hope is again abandoned and optimism gives way to disappointment, anger and despair.

Question – How should subscribers operate during the current bear market? As I see it, we are now in the early part of the second phase of this bear market. Investors are still optimistic, even though stocks, in general, have done poorly over the last three years.

I see safety as the prime consideration at this time. The second major consideration should be income. The last consideration should be the possibility of appreciation. For safety, one should think in terms of government bills, notes and bonds. But which government? I could say that Australian or Canadian government bonds. But I know that most subscribers are not going to go out and buy Canadian bonds.

My suggestion for most subscribers is to hold mostly top-grade government or muni bonds with maturities of no longer than ten years. You might hold some of the better utility stocks, particularly if they have dividend yields of 5% or more. And as an offset to a weaker dollar, war, terrorism or the declining purchasing power of dollars, I would suggest a fairly large commitment to gold and gold shares.

LATE NOTES – The newspapers have avoided it (or maybe they don't know about it), but I believe the major consideration today is the top-out of the dollar. There are three questions about the declining dollar. The first - how far down will the dollar sink? The second - how fast with the dollar sink? The third - how will the dollar's decline affect us?

Foreigners own a massive $8.2 trillion in US assets including (ominously) 40% of all US Treasury bonds. With US stocks in a declining trend, with housing in a bubble, with US leading indicators now turning down, foreigners have cut back on purchases of US securities and are turning in some of their dollars.

All of this is bullish for the one currency that nobody has doubts about (from a viability and longevity standpoint). That currency is gold. I list here 12 gold stocks. You should own a collection of at least five of these. They are HGMCY, GLG, GG, GFI, NEM, AEM, ABX, PDG, DROOY, MDG, BGO and CBJ.

Next mailing: June 19, 2002